

## The Disclosure of Projections Under Delaware Law

Over the past year, the Delaware Court of Chancery issued three decisions and one bench ruling that have fueled the debate concerning whether certain “soft information,” particularly financial projections, must be disclosed as a matter of Delaware law when a corporation is seeking stockholder approval of a merger transaction.<sup>1</sup> Those decisions indicate that a context-specific analysis, and not a rote legal standard, is necessary to determine whether projections are material, and thus must be disclosed, in a specific case under Delaware law. In employing such an analysis, the Court consistently applied the “fair summary” standard articulated in *In re Pure Resources, Inc.*<sup>2</sup> and considered similar factors when determining whether the projections were material, including (i) the reliability of the projections, (ii) the transaction structure, (iii) the utility of the projections, (iv) the target’s particular circumstances, (v) whether the projections were relied upon by the financial advisor and the target board, and shared with the bidder, and (vi) the presence of any partial or incomplete disclosure.<sup>3</sup>

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### Disclosure Under *Pure Resources*

It is settled Delaware law that directors have a duty to disclose to stockholders all material information in their possession when seeking stockholder approval of a merger transaction.<sup>4</sup> Information is material “if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote.”<sup>5</sup> For information to be material, it not only must be helpful, but also must “significantly alter[ ] the ‘total mix’

1 See *In re Netsmart Technologies, Inc. S’holders Litig.*, 924 A.2d 171 (Del. Ch. 2007); *In re CheckFree Corp. S’holders Litig.*, 2007 WL 3262188, Chandler, C. (Del. Ch. Nov. 1, 2007); *Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, Parsons, V.C. (Del. Ch. Nov. 30, 2007); *In re BEA Systems, Inc. Shareholder Litig.*, C.A. 3298, Lamb, V.C. (Del. Ch. Mar. 26, 2008) (Transcript).

2 808 A.2d 421 (Del. Ch. 2002).

3 This article is limited to the disclosure requirements of Delaware law and does not address the separate disclosure requirements of the federal securities laws.

4 See *Arnold v. Society for Savings Bancorp. Inc.*, 650 A.2d 1270, 1276 (Del. 1994).

5 *Louden v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997).

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of information made available.”<sup>6</sup> The Delaware courts have not stated definitively whether “soft information,” including pro forma statements underlying financial projections, and even raw data used by directors and their financial advisors, represents material information that must be disclosed to stockholders.<sup>7</sup>

The Court of Chancery took a step in that direction in *Pure Resources*. At issue in *Pure Resources* was a target corporation’s failure to disclose any of the substantive portions of the work performed by the target’s financial advisor in a Schedule 14d-9, issued in response to a tender offer by a controlling stockholder.<sup>8</sup>

In finding a reasonable probability of success on the disclosure claims, the Court stated that it was time to end the “ongoing debate” as to whether Delaware courts should require the “informative, succinct disclosure of investment banker analyses in circumstances in which the bankers’ views about value have been cited as justifying the recommendation of the board.”<sup>9</sup> The Court noted that the question as to whether such information should be disclosed had often been answered in an “intellectually unsatisfying manner” in order to avoid “stepping on the SEC’s toes” and encouraging “prolix disclosures.”<sup>10</sup> In an effort to rectify that problem, the Court promulgated a “firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely.”<sup>11</sup>

<sup>6</sup> *Netsmart*, 924 A.2d at 199 (quoting *Zirn v. VLI Corp.*, 621 A.2d 773, 778-79 (Del. 1993)).

<sup>7</sup> See, e.g., *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1977) (finding that when management “was in possession of two estimates from responsible sources using a ‘floor’ approach defining value in terms of its lowest worth, and the other a more ‘optimistic’ or ceiling approach defining value in terms of highest worth it is our opinion that complete candor required disclosure of both estimates”); *Louden*, 700 A.2d at 145 (“Speculation is not an appropriate subject for a proxy disclosure.”); *In re PNB Holding Co. S’holders Litig.*, 2006 WL 2403999, at \*16, Strine, V.C. (Del. Ch. Aug. 18, 2006) (finding that certain outdated projections were no longer reliable and therefore did not need to be disclosed).

<sup>8</sup> The target corporation argued that the Schedule 14d-9 contained historical financial information and certain projections of future results, and any additional information would not be material.

<sup>9</sup> *Pure Resources*, 808 A.2d at 449.

<sup>10</sup> *Id.* The Court noted that its decisions had acknowledged, more than occasionally, the “utility of such information” particularly given the “substantial encouragement Delaware case law has given to the deployment of investment bankers by boards of directors addressing mergers and tender offers.” *Id.*

<sup>11</sup> *Id.*

The Court determined that a “minority stockholder engaging in the before-the-fact decision whether to tender would find it material to know” three primary pieces of information in any “fair summary” of the substantive work performed by the financial advisor: (i) the basic valuation exercises undertaken by the financial advisor, (ii) the key assumptions relied upon by the financial advisor in performing the valuation exercises, and (iii) the range of values that were generated thereby.<sup>12</sup> Although *Pure Resources* set forth the “fair summary” standard, it remained unclear whether financial projections, or other raw data, must be included in that summary.

Following *Pure Resources*, the Court refused to require the disclosure of certain “soft information” in three notable decisions.<sup>13</sup> In *In re PNB Holding Co. Shareholders Litigation*,<sup>14</sup> however, the Court indicated that reliable projections relied upon by a target corporation’s financial advisor and board likely would need to be disclosed in connection with a cash-out merger transaction. Although the projections at issue in *PNB Holding* were outdated and unreliable, and therefore did not need to be disclosed, the Court stated as follows:

In the context of a cash-out merger, reliable management projections of the company’s future prospects are of obvious materiality to the electorate. After all, the key issue for the stockholders is whether accepting the merger price is a good deal in comparison with remaining a shareholder and receiving the future expected returns of the company.<sup>15</sup>

The Court cautioned, however, that not all projections need be disclosed in such circumstances and noted that “our law has refused to deem projections material unless the circumstances of their preparation support the conclusion that they are reliable enough to aid the stockholders in making

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<sup>12</sup> *Id.*

<sup>13</sup> See, e.g., *In re JCC Holding Co., Inc.*, 843 A.2d 713, 721-22 (Del. Ch. 2003) (finding that the board satisfied its duty to “make fair disclosure of the material facts in its possession bearing on the fairness of the merger it was putting before the stockholders....[by] setting forth a fair summary of the valuation work [the financial advisor] in fact performed,” including “certain input factors, ... such as discount rates and the costs of capital and equity used to derive them”); *PNB Holding*, 2006 WL 2403999, at \*16 (finding that certain outdated projections were no longer reliable and therefore did not need to be disclosed); *In re General Motors (Hughes) S’holder Litig.*, 2005 WL 1089021, at \*16, Chandler, C. (Del. Ch. May 4, 2005) (refusing to require the disclosure of raw data behind a financial advisor’s analyses and finding that “[a] disclosure that does not include all financial data needed to make an independent determination of fair value is not ... *per se* misleading or omitting a material fact”), *aff’d*, 897 A.2d 162 (Del. 2006).

<sup>14</sup> 2006 WL 2403999, Strine, V.C. (Del. Ch. Aug. 18, 2006).

<sup>15</sup> *PNB Holding*, 2006 WL 2403999, at \*15.

an informed judgment.”<sup>16</sup> Indeed, the Court noted that it was only in a minority of cases that the Court had found the disclosure of projections to be required and that in many cases projections were “too unreliable to warrant disclosure.”<sup>17</sup>

### Recent Guidance from the Court: *Netsmart*, *CheckFree*, *Globis Partners* and *BEA Systems*.

Over the past year, the Court had the opportunity to address more pointedly the issue of the disclosure of financial projections. Certain lessons can be drawn from those cases to assist practitioners in deciding whether projections should be disclosed in a particular situation.<sup>18</sup>

In *Netsmart*, Vice Chancellor Strine issued a limited injunction delaying a stockholder vote on a going private transaction. The Court considered, among other things, two claims relating to the omission of projections in the disclosures. Vice Chancellor Strine first declined to hold the omission of preliminary “stay the course” financial projections material since the final proxy statement included updated numbers that “were more current and more bullish,” and therefore more reliable.<sup>19</sup> On the second disclosure claim, however, the Court cited the “fair summary” doctrine and found that the corporation was required to disclose final revenue and earnings projections relied upon by its financial advisor and its board.<sup>20</sup>

With respect to the second disclosure claim, the Court found it important that earlier versions of the projections had been disclosed in the proxy statement, but that the final projections underlying the financial advisor’s fairness opinion had never been disclosed. The Court therefore concluded that “[o]nce a board broaches a topic in its disclosures, a duty attaches to provide information that is ‘materially complete and unbiased

<sup>16</sup> *Id.* at \*16. See also *McMillan v. Intercargo Corp.*, 1999 WL 288128, at \*6-7, Jacobs, V.C. (Del. Ch. May 3, 1999) (stating that “projections must be material in the context of the specific case” and that projections must be “sufficiently reliable evidence of value”); *Van de Walle v. Unimation, Inc.*, 1991 WL 29303, at \*17, Jacobs, V.C. (Del. Ch. Mar. 7, 1991) (“To be subject of a disclosure obligation, information relating to the value must be considered reliable.”).

<sup>17</sup> *PNB Holding*, 2006 WL 2403999, at \*17.

<sup>18</sup> *In re Netsmart Technologies, Inc. S’holders Litig.*, 924 A.2d 171 (Del. Ch. 2007); *In re CheckFree Corp. S’holders Litig.*, 2007 WL 3262188, Chandler, C. (Del. Ch. Nov. 1 2007); *Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, Parsons, V.C. (Del. Ch. Nov. 30, 2007); *In re BEA Systems, Inc. Shareholder Litig.*, C.A. 3298, Lamb, V.C. (Del. Ch. Mar. 26, 2008) (Transcript).

<sup>19</sup> *Netsmart*, 924 A.2d at 200

<sup>20</sup> *Id.* at 203-4.

by the omission of material facts.”<sup>21</sup> Although the bidders may not have received certain years of those final projections, the Court still found those projections to be material since the stockholders, “unlike the bidders, have been presented with [the financial advisor’s] fairness opinion and are being asked to make an important voting decision to which [the corporation’s] future prospects are directly relevant.”<sup>22</sup> Thus, Vice Chancellor Strine reaffirmed the views he expressed in *Pure Resources* that in the context of a cash-out merger, where investors forsake a future financial interest in the corporation, the stakes for the stockholders are higher, and the need for the disclosure of reliable projections is therefore heightened.<sup>23</sup> The Court explained as follows:

Indeed, projections of this sort are probably among the most highly-prized disclosures by investors. Investors can come up with their own estimates of discount rates or (as already discussed) market multiples. What they cannot hope to do is replicate management’s inside view of the company’s prospects.<sup>24</sup>

Eight months after *Netsmart*, Chancellor Chandler decided *CheckFree* and rejected a similar claim. At issue in *CheckFree* was the omission of certain projections in a target corporation’s disclosures relating to a merger transaction. Plaintiff stockholders moved to enjoin the merger, arguing, among other things, that the target corporation’s proxy statement failed to disclose underlying financial projections used by its financial advisor to render its fairness opinion.<sup>25</sup>

In denying the injunction, Chancellor Chandler focused first on whether the board’s failure to provide cash flow projections shared with the buyer and relied upon by the target corporation’s financial advisor represented a material omission.<sup>26</sup> While the plaintiff cited disclosure decisions pertaining to appraisal actions for the proposition that directors were required to disclose “all of the data underlying” the financial advisor’s fairness opinion,<sup>27</sup> Chancellor Chandler refused to recognize a *per se* rule requiring the disclosure of such data in every case.<sup>28</sup> Deciding instead that stockholders must show that additional disclosures would “alter the total

<sup>21</sup> *Id.* at 203 (quoting *Pure Resources*, 808 A.2d at 448).

<sup>22</sup> *Id.* at 202.

<sup>23</sup> *Id.* at 203. The Court noted that the disclosure of projections in a cash-out merger was especially important where “most of the key managers seek to remain as executives and will receive options in the company once it goes private.” *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *CheckFree Corp.*, 2007 WL 3262188, at \*2.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

mix of information” available to stockholders, the Court determined that the correct legal standard remained the “fair summary” standard articulated in *Pure Resources*.<sup>29</sup> In holding that the proxy statement satisfied the Pure Resources standard, the Court noted that the proxy statement:

. . . details the various sources upon which [the financial advisor] relied in coming to its conclusions, explains some of the assumptions and calculations management made to come to its estimate, notes exactly the comparable transactions and companies [the financial advisor] used, and describes or otherwise discloses management’s estimated earnings and estimated EBITDA for 2007 and 2008 and a range of earnings derived from management estimates for 2009 . . . [I]n tandem with conveying its estimates, management discussed the particular risks it foresaw that might undercut those estimates.<sup>30</sup>

The Court then distinguished *Netsmart*, noting that the proxy statement at issue in that case contained a partial disclosure and therefore further disclosure was required. Perhaps more important, the proxy statement at issue in *CheckFree* warned that the financial advisor had interviewed members of the target corporation’s management team in order to understand the risk factors that threatened the accuracy of the projections. The Court reasoned that “[t]hese raw, admittedly incomplete projections are not material and may, in fact, be misleading.”<sup>31</sup>

A few weeks after Chancellor Chandler issued his opinion in *CheckFree*, Vice Chancellor Parsons weighed in on the disclosure debate. In *Globis Partners, L.P. v. Plumtree Software, Inc.*,<sup>32</sup> a plaintiff stockholder alleged that the absence of “meaningful projections” of the target corporation’s future performance was a material omission.<sup>33</sup> Finding that the omission of projections is material only if the projections are reliable, the Court rejected the disclosure claim because the plaintiff did not allege that the target corporation “had reliable projections or any other facts that reasonably would call into question the veracity or adequacy of this aspect of [the] disclosure.”<sup>34</sup> Instead, the plaintiff merely focused on challenging the financial advisor’s judgment that the projections were unreliable and unhelpful. The Court found that “[s]uch criticisms do not constitute a sufficient basis for a breach of disclosure claim.”<sup>35</sup>

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<sup>29</sup> *Id.* at 2-3.

<sup>30</sup> *Id.* at \*3.

<sup>31</sup> *Id.* at \*2.

<sup>32</sup> 2007 WL 4292024 (Del. Ch. Nov. 30, 2007).

<sup>33</sup> *Id.* at \*12.

<sup>34</sup> *Id.* at \*13.

<sup>35</sup> *Id.*

Most recently, in a bench ruling, the Court denied a motion to enjoin a stockholder vote despite allegations of the material omission of certain underlying financial data.<sup>36</sup> The financial data at issue in *BEA Systems* included, among other things, projections that the financial advisor had used to prepare a preliminary discounted cash flow analysis prior to the emergence of the acquiror, certain synergy estimates, and low and high case sensitivity analyses. The Court refused to find such information material because it was not reliable, could mislead stockholders rather than inform them in this specific case, and had not been relied upon by the financial advisor and the board. Importantly, the Court stated that “the fact that something is included in materials that are presented to a board of directors does not, *ipso facto*, make that something material.”<sup>37</sup>

### Practical Implications: Is the Disclosure of Projections Required?

*Netsmart*, *CheckFree*, *Globis Partners* and *BEA Systems* lead to one unified conclusion—that a context-specific analysis is required to determine whether projections must be disclosed in a particular situation.<sup>38</sup> The following lessons can be drawn from those decisions:

**The Pure Resources “Fair Summary” Requirement.** *Pure Resources* continues to be the starting point for determining whether projections must be disclosed.<sup>39</sup> A “fair summary” of the substantive work performed by a financial advisor must be disclosed, including (i) the basic valuation exercises, (ii) the key assumptions, and (iii) the range of values generated. Although *Pure Resources* provides some guidance, there is no “checklist” of the types of information underlying the financial advisors opinion that must be disclosed.<sup>40</sup> Whether the “fair summary” requirement has been satisfied in a particular situation, therefore, must be decided on a case-by-case basis.

<sup>36</sup> *In re BEA Systems, Inc. Shareholder Litig.*, C.A. 3298, Lamb, V.C. (Del. Ch. Mar. 26, 2008) (Transcript).

<sup>37</sup> *Id.*, Tr. at 100.

<sup>38</sup> The Court of Chancery favors a similar approach when analyzing deal protections. See *In re Toys “R” Us S’holder Litig.*, 877 A.2d 975, 1015-16 (Del. Ch. 2005).

<sup>39</sup> *Netsmart*, 924 A.2d at 204; *CheckFree*, 2007 WL 3262188, at \*3; *Globis Partners*, 2007 WL 4292024, at \*11.

<sup>40</sup> *CheckFree*, 2007 WL 3262188, at \*3; *Globis Partners*, 2007 WL 4292024, at \*11.

**Materiality Remains the Touchstone.** Only projections that are material, not those that are merely helpful, must be disclosed. Indeed, the Court has stated that “[a] disclosure that does not include all financial data needed to make an independent determination of fair value is not ... *per se* misleading or omitting a material fact.”<sup>41</sup>

**Reliability is Key.** The recent case law is clear that projections are not material unless they are reliable.<sup>42</sup> As demonstrated in all three cases, projections that are unreliable or misleading need not be disclosed.<sup>43</sup> If projections are reliable, however, the materiality of those projections is significantly heightened at least in the context of cash-out or going private merger transactions.

**The Transaction Structure.** The materiality of projections is heightened in cash-out merger transactions, where the stockholders are being asked to evaluate whether to accept the merger consideration or to continue as stockholders of the corporation.<sup>44</sup> The materiality of projections is heightened uniquely in going private transactions, and particularly where “key managers seek to remain as executives and will receive options in the company once it goes private.”<sup>45</sup> Although not addressed in the recent cases, it follows that the materiality of a *buyer’s* projections is heightened in stock-for-stock merger transactions, in which the target corporation’s stockholders must evaluate the “price” to be paid in the form of the buyer’s shares.

**Utility of Projections.** If projections are reliable, disclosure may not be required if the projections are of questionable utility to the stockholders. For example, the Court in *Netsmart* found that certain “stay the course” projections were not material because they were in fact more pessimistic and therefore actually demonstrated that the merger consideration was “fairer” than the proxy statement implied.<sup>46</sup>

41 *CheckFree*, 2007 WL 326188, at \*2 (quoting *Gen. Motors*, 2005 WL 1089021, at \*16). See also *Globis Partners*, 2007 WL 4292024, at \*11 (“The fact that the financial advisors may have considered certain non-disclosed information does not alter this analysis.”).

42 *Netsmart*, 924 A.2d at 201; *CheckFree*, 2007 WL 3262188, at \*3; *PNB Holding*, 2006 WL 2403999, at \*16; *BEA Systems*, Tr. at 90-93.

43 *Netsmart*, 924 A.2d at 201; *CheckFree*, 2007 WL 3262188, at \*3; *Globis Partners*, 2007 WL 4292024, at \*11.

44 *Netsmart*, 924 A.2d at 200, 203; *PNB Holding*, 2006 WL 2403999, at \*16.

45 *Netsmart*, 924 A.2d at 203.

46 *Id.* at 200. The Court also questioned the reliability of the “stay the course” projections.

**The Target's Unique Circumstances.** Any unique circumstances should be considered when determining whether projections are material. In *Netsmart*, for example, the Court found that the projections were particularly important, and thus of heightened materiality, because the corporation's unique market niche made a comparable company analysis less useful.<sup>47</sup>

**Reliance By the Financial Advisor and Board; Sharing with Bidders.** Projections relied upon by the target corporation's financial advisor and board, as well as those shared with bidders, are more likely to be material and thus to require disclosure.<sup>48</sup> Those facts standing alone do not necessitate disclosure, however, as the projections must still be reliable and otherwise material in the particular circumstances.<sup>49</sup>

**Partial Disclosure or Incomplete Disclosure.** The partial disclosure of financial projections that fail to offer the best estimate of a corporation's future financial performance triggers a broader fiduciary obligation to supplement the proxy with materially complete information.<sup>50</sup> Once a board "opens the door" to partial disclosure, more complete information may be necessary.

## Conclusion

The Delaware courts have not articulated a rote legal standard or checklist providing clear guidance whether projections must be disclosed in a particular situation. Rather, a context-specific analysis is required to determine whether projections must be disclosed. Pending further guidance from the Delaware courts, practitioners should focus on whether the disclosure provides a "fair summary" of the substantive work performed by the corporation's financial advisor and relied upon by the corporation's board and whether that "fair summary" requires the disclosure of reliable projections in the specific circumstances at issue.

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<sup>47</sup> *Id.* at 203.

<sup>48</sup> *Pure Resources*, 808 A.2d at 450; *JCC Holding Co.*, 843 A.2d at 720.

<sup>49</sup> *BEA Systems, Tr.* at 100.

<sup>50</sup> *Netsmart*, 924 A.2d at 199-200; *Pure Resources*, 808 A.2d at 448.